INCOME DISTRIBUTION POLICY IN THE NETHERLANDS: A PARADIGM SHIFT

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ABSTRACT

This paper investigates which different views have occurred on the main lines of the Dutch incomes policy. To this end the implications of the incomes policies pursued by different cabinets have been analyzed, mainly since 1973. It appears that distributive policies are heavily influenced by a paradigm shift. In the 1970s, the Dutch government replaced its keynesian oriented economic policy making with a neoclassical framework. As a result, the government not only moved from an interventionist approach in the 1970s to a restrained attitude in the 1980s and 1990s, but also altered the institutional framework of its distributive policies by abolishing a number of policy instruments that had been created to influence the size distribution of incomes.

INTRODUCTION

Income formation and income distribution are closely interrelated. On the one hand, the income distribution is a by-product of the more comprehensive economic process, i.e., the entire process of production and consumption. On the other hand, the income distribution results from a politically oriented process of redistribution. Government not only acts as a household in the market place, but also as a ruling body taking responsibility for the institutional framework within which economic subjects take decisions.

How far government's influence goes, is essentially a political question. Thus, the answer depends on political norms and values. The cabinet-Den Uyl (1973-1977) stated for three reasons that government and the legislator bear final responsibility for an incomes policy. First, the government has specific duties with regard to certain groups. A large part of the income transfers results from this notion, in particular the part benefiting socio-economically vulnerable groups. Second, income distribution policy is an essential part of social and economic policies in general, deriving certain governmental responsibilities. Third, individual and household incomes determine to what extent individuals and households share in society's welfare.

In a note on incomes policy, the Dutch Ministry for Social Affairs elaborated the basis and principles of the incomes policy to be pursued.[i] Initially, the main lines set out by the (center-left) cabinet-Den Uyl (1973-1977) did not seem particularly controversial, since its successor - the (center-right) cabinet-Van Agt I (1977-1981) - endorsed these main lines. At the end of its term, however, this conclusion seemed premature. In an evaluation of the incomes policy pursued in the 1980s, the minister for Social Affairs presented policy principles that in his view deviated from those adopted in the 1970s.[ii]

This paper investigates to what extent different views have occurred on the main lines of the Dutch incomes policy, taking the existing economic system as a given. To this end the implications of the incomes policies pursued by different cabinets have been analyzed, the main focus being the period from 1973. The remainder of this paper is organized as follows. Section 2 deals with different income distributions that can be discerned and the policies pertaining to these distributions. Section 3 identifies the instruments of distributive policies and touches upon two of them. In addition, it analyses the use of the two main policy instruments: pay policy and redistribution policy, respectively. In section 4 the main policy implications are discussed, while section 5 summarizes the main conclusion.

INCOME DISTRIBUTIONS AND POLICIES

Several income distributions can be discerned: the functional income distribution, the categorical income distribution, and the personal income distribution. The *functional* income distribution pertains to factor pricing. Therefore, it forms part of the price theory. Despite serious criticisms,[iii] the (neoclassical) marginal productivity theory has maintained its important position in economic theory, particularly in the theory of factor prices. Though after World War II the keynesian approach dominated the Dutch political scene, the orientation of policy makers gradually shifted in the 1970s. By the end of the decade policy makers appeared to have adopted the neoclassical equilibrium school of thought.

Since then Dutch policies have been dominated by neoclassical reasoning, though primarily in macroeconomic policy. As a result, a wage moderation policy was adopted which aims at wage rises that lag behind those in neighboring countries. This wage moderation policy was inspired by considerations of employment policy. To a lesser extent the neoclassical line of thought also affected distributive policies, for example because policy makers began to stress the allocative function of income differentials, though without affecting the basically egalitarian nature of the Dutch society.

The *categorical* income distribution pertains to the shares of the different factors of production in GDP, such as the wage share, the profit share, etc. In the Netherlands, the so-called labor income share is frequently used as a measure for the categorical income distribution. It represents the share of labor in the value added produced in the market sector including an imputed labor income of the self-employed.[iv] After World War II, the labor income share was at a considerably higher level than in the pre-war period, as Table 1 displays. In particular in the 1960s and 1970s it increased structurally and its complement - the share of other incomes - consequently decreased. This is notable, since the production simultaneously has become more capital intensive in the sense that the quantity of capital per unit of labor has increased.

TABLE 1
Labor Income Share (LIS) in the
Market Sector in the Netherlands, 1930-1998

	1930	1938	1948	1958	1968	1978	1988	1998
LIS	67	67	81	73	77	79	84	80[a]

a. Estimate

Source: Central Planning Bureau, The Hague.

In Dutch distributive policy, the categorical income distribution has never gained a prominent position. Government did pay attention to it, however, in the framework of its employment policy. In the first and second stages of the post-war wage policy (1945-

1958) the categorical income distribution explicitly played a certain role, but later on it occurred implicitly at most. Particularly after policy makers had accepted the (neoclassical) vintage approach[v] more attention has been paid to the development of the labor income share. However, this has never led to the explicit formulation of a policy goal in terms of this share.

The third distribution to be discerned is the *personal income distribution*. Generally, the theoretical state of affairs with regard to this distribution is considered unsatisfactory. The shortcomings in theoretical insights is not the consequence of a lack of theories - the number of theories pertaining to the personal income distribution is actually quite large - but rather the consequence of the fact that neither of the available theories is considered to be satisfactory. Stochastic theories[vi] and the human capital theory[vii] are in a sense extremes that are situated at opposite ends of the spectrum. Chance and luck play the leading part in stochastic theories, whereas the human capital theory leaves no room for chance and luck at all.

Of the theories trying to explain the personal income distribution, Tinbergen's theory seems the most complete, since this theory explicitly comprises both supply and demand.[viii] In this theory education plays a significant role in explaining the personal income distribution. This is supported by empirical evidence in many countries, though the size of the schooling premium varies across countries, by educational attainment and over time (also within countries).[ix] Table 2 illustrates that the strong relationship between education and income also occurs in the Netherlands.

Because of the increased wage share the income distribution over wage earners has grown in importance. In addition, factors such as experience and on-the-job-training have increasingly been contributing to the heterogeneity of the production factor labor. As a result, the labor class has become extremely heterogeneous. In combination with the increased wage share in GDP this has led to a situation in which the stratification within the group of wage earners is actually more important than the ricardian division in three socio-economic categories (laborers, capitalists and landlords) both from the sociological point of view and from the perspective of the personal income distribution. Relevant is now the distinction according to educational and wage levels, which are closely interconnected.

TABLE 2
Ratios of Average Gross Monthly Wages of Full Time Employees in Production and Service Sectors According to Age and Educational Level

Age	Year	Education		
		Primary	Secondary	Tertiary
23-34	1979	100	120	182
	1985	100	113	164
	1989	100	108	152
45-64	1979	100	159	229
	1985	100	155	199
	1989	100	146	231

Source: Central Bureau of Statistics, The Hague.

Traditionally, Dutch public policy pays much attention to the personal income distribution. However, an analysis of policy documents[x] shows that policy makers have always confined themselves to presenting descriptions of the existing income distribution or to a judgment of income differentials in qualitative terms. They have never formulated a clear-cut, quantitative goal, for instance in terms of some inequality measure or certain income ratios. Rather, policy makers have limited themselves to a vague and qualitative distributive goal - such as an `acceptable' or `reasonable' income distribution - without providing concrete and testable details. Contrary to economists, Dutch policy makers do not use the term optimal income distribution.

POLICIES AS TO INCOME SOURCES

The main instruments of the incomes policy are the *sources policy*, the *pay policy*, and the *redistribution policy*. The income sources policy pertains to income generating characteristics that can be influenced. Therefore, it is the most fundamental instrument. It affects the income distribution in the long run and potentially structurally. Labor is the far most important source of income. The policy with regard to pay for labor is dealt with under the heading pay policy, which is followed by a subsection addressing the redistribution policy. But first I will briefly touch upon the sources policy.

Sources Policy

The Dutch wealth policy does not aim at spreading existing wealth, rather it aims at the spread building up of new fortunes. In the framework of this policy measures have been taken to foster savings. The wealth policy pursued in the Netherlands does not seem to have been motivated all too consistently, which may be explicable from the fact that it has always been a politically highly controversial subject. In the 1970s, an arrangement for capital growth sharing was proposed. Both the collective element and the legal obligation in the proposed arrangement led to conflicts within the ruling coalitions. However, the deteriorating employment situation in the early 1980s led to a higher priority for an employment policy. As a result, the subject of the (collective) capital growth sharing arrangement faded away and political attention shifted to profit sharing and employees' savings arrangements, which are freely negotiated and agreed upon by employers and employees.

As to the income source of power the competition policy is relevant. In the Netherlands, abuse of economic power is combatted by a competition policy, which has been strengthened in the 1980s along two tracks.[xi] First, through general bans on horizontal price arrangements, market sharing and procurement arrangements, and an amendment of the *Act on Economic Competition* aiming at reinforcing the law's effectiveness. Because of the general bans the abuse system has *de facto* already been changed into a prohibition system. The second track along which the competition policy is to be strengthened, is the bill *New Rules on Economic Competition* entailing a complete revision of the *Act on Economic Competition* (Ministry of Economic Affairs, 1996).[xii] The new rules are based on a prohibition system - also *de jure* - and are linked on to the competition rules of the European Union. This development suits the altered theoretical framework of economic policy making, since it shifts the emphasis from government intervention to the operation of markets and the price mechanism.

Pay Policy

Certain laws enable the government to directly affect specific dimensions of the pay of large groups participating in the production process. A pay policy pertaining to self-employed hardly exists, but the wage policy pursued from 1945 implies that wage determination has never been completely free. Government has always played a certain role, either directly by actively influencing wage determination or indirectly by the threat of government intervention. In 1983, however, the government altered its attitude radically by adopting the view that government should act more restrained and should thus break with the tradition of frequent interference in income formation in the market sector.

As a result, the institutional framework has been altered, for example by an amendment of the *Wage Determination Act* in 1986. This amendment curtailed government's competency to intervene in wage determination by dictating that any interference had to be general (as opposed to specific) in character. Two causes can be identified for this development: market forces and international treaties. The first cause refers to the increased unemployment rate, which in itself already fostered a moderated wage development. This removed the need for government to fight or discourage buoyant wage hikes. The second cause refers to the continuous criticism of the *International Labour Office* (ILO) as a response to repeatedly deposited complaints of trade unions and employers' organizations pertaining to a lack of freedom to negotiate because of government intervention in wage determination.[xiii]

With respect to public sector workers a so-called trend policy has been pursued in the 1970s, implying that public sector wage adjustments were in line with private sector wage developments. In the 1980s, however, this policy has gradually been replaced with a more autonomous policy, implying that public sector wage adjustments depend on budgetary possibilities. Moreover, centralized wage bargaining has been replaced in 1993 with the so-called sector model, which essentially means decentralization of wage bargaining over eight subsectors. Only the terms concerning pensions, disability benefits, and early retirement remain subjects for bargaining on the central level. This development can be characterized as `normalization' of labor relations in the public sector.

In the subsidized sectors the government not only acts as employer, but also as financier. Expenditure in these sectors are publicly funded, i.e., they are for government's and/or social insurance funds' accounts. Since the government is responsible for the use of public money, this is considered to be a reason for government interference with the terms of employment in the subsidized sectors. As of 1980 the *Temporary Act Terms of Employment in the Public Sector* granted the government the competency to interfere directly with the terms of employment in the subsidized sectors. Developments in the market sector (decentralization of wage determination) and criticisms of the ILO about a lack of bargaining freedom in the subsidized sectors, contributed to the replacement of the temporary act with the *Act Terms of Employment in the Subsidized Sectors*, which was an intermediate step toward normalization of labor relations in the subsidized sectors. However, the ILO continued to criticize the situation of wage determination in the subsidized sectors - particularly the possibility to freeze the terms of employment - while the Social Economic Council[xiv] advised to repeal the *Act Terms of Employment in the Subsidized Sectors*. As a result, the act has been repealed as of January 1, 1995, thereby taking another step on the road toward normalized labor relations in the public sector.

In 1978, the enactment of the temporary *Act on Wages not Based on Collective Agreements* enabled the government to interfere with terms of employment that are not determined by collective agreements. When this act expired by December 31, 1983 the government anticipated the planned amendment of the *Wage Determination Act* of 1986. Though the *Act on Wages not Based on Collective Agreements* was prolonged until January 1, 1987, the government did not avail itself of the competencies granted by this act. Since in 1984 and 1985 no extreme deviations in terms of employment occurred in the non-collectively determined wages compared to collectively determined wages, the government concluded that legislation in this field was no longer necessary. Thus, the temporary act has not been prolonged nor converted into structural legislation. Obviously, the government has retreated with regard to the non-collectively determined wages.

Since the early 1970s the government aimed at regulating the incomes of the professions.[xv] Initially, it did so in the framework of the *Act on Prices*, but decision by a judge made this impossible. The government responded by creating the *Temporary Act Regulation of Professional Incomes*. Practice shows, however, that this has only affected the medical sector.[xvi] In 1985, the Social Economic Council[xvii] advised not to prolong this act, but rather to pursue a competition or sources policy to tackle the market imperfections causing too high incomes. The government did not follow this advice, rather it elected to create the *Act on Professional Incomes*. However, this act halted between two opinions.[xviii] On the one hand, the government wanted to retreat and to give room to market forces. On the other hand, the government wanted to interfere to fight undesirable effects resulting from an unequal division of power. With regard to the *Act on Professional Incomes* the same conclusion holds as to the *Temporary Act Regulation of Professional Incomes*. The act primarily served as a symbolic expression of a government aiming at controlling all incomes. Thus, it reflected the ideological climate dominating the political scene until the late 1970s and preceding the ideology of deregulation and a retreating government that came up in the 1980s.

Redistribution Policy

An important instrument of redistribution policy is the tax policy. This appears to be subject to fluctuations. During some periods the egalitarian effect of the tax policy has been reinforced, whereas in other periods it has been weakened. In the long run, however, taxes - in particular the income tax - have contributed to a considerable extent to the equalization of incomes. Table 3 shows that the effect of social security contributions is slightly progressive as to the lower tail of the income distribution, but regressive with regard to the higher tail of the income distribution. Obviously, the progressivity of the income tax outweighs the regressivity of social security contributions. As a result, the overall effect of taxation is progressive.

Measured by the variation-coefficient and the Theil-coefficient, the income tax results in a reduction of the income inequality in the order of 30-40%.[xix] Possible behavioral responses (such as tax evasion) and statistical distortions make it impossible to determine the real reduction of income inequality. Moreover, it makes a difference whether the effect of tax measures is analyzed statically or dynamically. In the period 1990-1994, for instance, a package of measures was taken that affected the lower income brackets more favorably than the higher income groups. A dynamic analysis, however, leads to the conclusion that a large part of the reduction of the burden for the lower income brackets has faded away as a result of the increased micro progression factor.[xx]

Income transfers in cash are a second instrument of redistribution policy. The redistributive effect of all income transfers was very large in 1977: 46% measured by both the Gini-coefficient and the variation-coefficient, 73% according to the Theil-coefficient, and 92% measured by the ratio of income shares of the tenth and third deciles.[xxi] In 1981, the equalizing effect by income transfers was even greater,[xxii] but in 1991 it was somewhat smaller than in 1977.[xxiii] The latter development suits the greater emphasis policy makers have laid on the allocative function of income differentials. Generally, the income redistribution can primarily be contributed to social benefits and to a smaller extent to the income tax and social security premiums. Moreover, the redistribution of incomes primarily occurs at the upper and lower tails of the income distribution.

The policy of adjusting social benefits to the development of wages appears to have been changing. In 1957, when the public pension system was enacted, the old age benefits were pegged to the wage index. This mechanism served as a model for other benefits. However, an automatic adjustment mechanism of social benefits to wage developments as laid down in 1980 in the *Act Adjustment Mechanism Minimum Wage and Social Benefits* appeared to raise so many problems, that the act has hardly been applied. Temporary measures *ad hoc* led to a practice that strongly deviated from the legal arrangement. In 1992, therefore, the automatic linking mechanism was replaced with a politically determined adjustment, enabling the government to link on more accurately to the economic development.

TABLE 3
Average Burden of Payroll Taxes, General Social Security Contributions, and Income Tax for Single Earners with Children as a Percentage of Gross Income (Exclusive of Pension Premiums), 1994

Gross income[a]	Payroll taxes	General social security contributions	Income tax	Total burden
Minimum	8.1	9.8	4.3	22.2
Standard	10.7	12.0	5.3	28.0
2x Standard	11.2	5.1	23.8	40.1
4x Standard	5.6	2.6	40.1	48.3

a. In 1994, the minimum income amounted to over NLG 28,000 (approximately $14,000), while the standard income amounted to nearly NLG 49,000 (approximately $24,500).

Source: Calculated on the basis of Ministry of Finance. ***Bouwstenennotitie***, Ministry of Finance, The Hague, 1994, Part II, Annex 1 (Table 3).

A third instrument of redistribution policy are income transfers in kind, comprising both transfers *from* the government (such as rent subsidies) and transfers *to* the government (indirect taxes). In the Netherlands, income transfers in kind appear to affect the income distribution only to a small extent. The redistributive effect of the in-kind-transfers amounts to 3% of the initial income inequality, while the corresponding figure as to the indirect taxes amounts to 2%. Yet, they bring about considerable shifts in the income distribution. Approximately 30% of the households move at least one decile down and approximately 20% move at least one decile up under the influence of income transfers in kind.[xxiv]

The government provides certain goods and services free or for a lower price than its cost. Also, the government provides price subsidies for certain goods and services delivered by third parties. In a number of cases the government avails itself of income related subsidies or income prices. As a result, the price of the provision under consideration increases according to the user's income until a certain limit. The cumulative effects of these arrangements may pose a problem in that they may result in extremely high overall marginal rates. However, practice shows that in the Netherlands there are virtually no households with an overall marginal rate of over 100%.[xxv] One per cent of the households face an overall marginal rate of 80-100% and 12% face a rate of 60-80%. Though income prices and the resulting extreme overall marginal rates may disturb the labor market, it appears that this does not occur at a large scale.

POLICY IMPLICATIONS

Until the mid-1970s Dutch economic policy making was dominated by the keynesian line of thought. When the economic climate began to change in the 1960s, interest emerged in structural concepts such as production capacity. The Central Planning Bureau[xxvi] developed models that explicitly paid attention to the supply side of the economic process.[xxvii] Since then, the essence of the neoclassical line of thought can be found in the models used by the Central Planning Bureau and, consequently, in the process of policy making. However, society was not yet ready to adopt this change in policy view. Societal acceptance was delayed until the early 1980s.[xxviii]

Retrospectively, the cabinet-Den Uyl (1973-1977) seems to have been a transition cabinet. Starting as a keynesian oriented cabinet, it attempted to cope with the diminishing economic growth by expanding the public sector, resulting in an increasing budget deficit and a rising tax burden. However, during its term non-keynesian insights began to influence policy makers, while the break in policy makers' line of thinking was completed during the cabinet-Van Agt I (1977-1981). This cabinet explicitly gave up keynesian oriented politico-economic concepts. As a result, concepts such as `overspending' and `cyclical injections' were replaced with concepts such as `real wage cost moderation' and `production cost'.

The policy of the cabinet-Van Agt I is consistent with the views and insights emerging in the mid-1970s. Though in practice the cabinet's policy appears to have been a paper tiger,[xxix] the government gradually adjusted the institutional framework to its changed paradigm by abandoning a number of policy instruments that may be used to affect wages and other incomes. After the adoption of the (neoclassical) vintage approach the government paid more attention to the development of the share of labor in the value added produced in the private sector. However, it has never explicitly formulated a policy goal in terms of labor's share, which contrasts with the first two stages of the post-war wage policy (1945-1958).

Policy documents fail to make clear which theoretical approach with regard to the personal income distribution has been adopted. The papers show that the government confines itself to descriptions of the existing income distribution or to qualitative judgments of income differentials. Moreover, the rather vague goal of an `acceptable' income distribution has never been formulated in concrete and quantitative terms, for example in terms of the reduction of a certain inequality measure. Because of the absence of a clear and concrete goal, a judgment of the policy with regard to the income distribution must be limited to the observation of this absence.

An interventionist government which intensively interferes with the economic process suits the keynesian line of thought. Government intervention seems a logical consequence of the role of government within this theoretical framework. The neoclassical equilibrium concept, however, stresses the market mechanism and leaves little room for government intervention in the economic process. A non-interventionist government better suits the neoclassical framework. Against this background of an altering theoretical framework of policy making it is explicable that in the 1980s the government gave up a number of policy instruments designed to influence wages and other incomes.

The change of the theoretical framework of policy making appears to be coupled to more emphasis on the allocative function of income differentials. The income sources, with education being one of the most important, are highly relevant in this context. The development of the wage ratio between the higher and the lower educated seems consistent with the transformation of the theoretical framework of policy making. The wage ratio of all age categories decreased between 1962 and 1972, which is consistent with the egalitarian ideology prevailing in the 1960s and 1970s. Inconsistent with this ideology, however, is that the equalization of incomes of the 1960s has largely been undone for large groups in the 1970s. Moreover, wages of workers younger than 45 years seem to have been re-equalized in the 1980s, which is inconsistent with the ideological change that occurred in this period. Increasing income inequality, however, can be observed in other categories of workers, which better suits the ideology of a retreating government in the 1980s and the prevailing policy view emphasizing the allocative function of income differentials.

Also consistent with the changed theoretical framework is the aloof attitude of the government with respect to wage formation. The government's authority to interfere in wage formation was severely limited by the amendment of the *Act on Wage Formation* of 1986, while a `normalization' of labor relations has emerged in the public sector. The price/incomes policy with regard to the professions has merely led to a temporary change of the economic system - from the early 1970s until the early 1990s - and has brought about only small effects. Other measures than a direct incomes or price policy seem more effective in the long run, such as an increase of the number of public notaries. This links on to the greater emphasis that policy makers put on the market principle. The rise and fall of the price/incomes policy for the professions seem to mirror the changed theoretical framework of the economic policy making, i.e., the gradual replacement of the ideology of an interventionist government in the 1970s with the ideology of a retreating government in the 1980s and 1990s.

CONCLUSION

The changed theoretical framework of policy making has affected the Dutch government's policies profoundly. As to the income distribution policy the move from an interventionist to a retreating government finds expression in the scrapping by government of a number of policy instruments to influence the income distribution and an ever less detailed government interference with the income distribution. In this respect, however, the instrument of tax expenditures seems to be an exception in the 1990s. This instrument has more intensively been used since the early 1990s,[xxx] but its effects on the income distribution are not yet clear.

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$$LIS_m = \frac{w_m(E_m + S)}{Y_m}$$

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